DOI:10.24193/tras.54E.2
Published First Online: 2018/06/29

WITH A PERMANENTLY PRO-CYCLICAL FISCAL POLICY, WE COULD LOSE DEMOCRACY AND MONETARY POLICY

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Abstract

This article shows that if, in a young democracy with weak institutions, one and the same party governs in virtually all upswings of the business cycle and promotes each time pro-cyclical fiscal policies, three serious negative effects emerge. The first is the loss of fiscal policy; fiscal policy remains pro-cyclical during the downturn as well, deepening the recession and extending the period in which output stays below potential. The second effect is the loss of democracy; unable to use fiscal policy to help exit the recession and speed up economic growth, the parties governing during downturns compounded by the pro-cyclicality of fiscal policies are perceived by the public as impotent and are penalized accordingly through a lower share of parliamentary seats, until the party that governs exclusively during business cycle upturns finds itself without a real opposition. The third effect is the loss of conventional monetary policy, manifesting if interest rates and inflation are low when recession sets in. Under these circumstances, lowering the monetary policy rate to zero might no longer suffice to stimulate the exit from recession and the quick return of output to its potential level, leaving central banks no option but to resort to unconventional monetary policies, such as quantitative easing.

Keywords: fiscal cynicism, business cycle, pro-cyclical fiscal policy, monetary policy, democracy, political parties.

1. Introduction

Over the past two decades, Romania's fiscal policy has been mostly pro-cyclical, i.e. its fiscal impulse and output deviation from potential have been concomitantly either positive or negative. Pro-cyclical fiscal policies increase growth rates in the business cycle upswings and lower them even more to very negative levels in recessions. Politicians in Romania have not learned this lesson yet. In 2017, despite a GDP growth rate of about seven percent and an excess demand of about 2.9 percent of potential GDP, the government decided to administer the economy a positive fiscal impulse of about 1.4 percentage points.

In this article I will focus on two issues. First, I will come up with two possible explanations for promoting a pro-cyclical fiscal policy in Romania during periods of swift economic growth, at rates above potential, partially fueled by the fiscal policy itself. The need for such explanations arises because, unlike the monetary policy, which is partly insulated from political interference, the fiscal policy is formulated in an intricate political process. Neglecting this process may lead either to misunderstanding or underestimating long-term trends which, as I will show, erode democracy or to unrealistic conclusions about how to preserve a correct fiscal policy stance at all times.

Then I will analyze the consequences of the expansionary fiscal policy separately for the 'normal' phases of the business cycle, when monetary policy rates are significantly positive, and for the 'abnormal' phases, when policy rates are virtually equal to zero. Experience so far has shown that, during normal business cycle phases, if the short-term Phillips curve (the link between inflation and excess demand) is not flattened (i.e. excess demand generates relatively high levels of inflation), a pro-cyclical fiscal policy during the expansion entails a massive rise in inflationary pressures, which calls for higher interest rates. Then, when the economy inevitably enters the contraction phase, fiscal policy remains pro-cyclical, this time unintentionally, deepening recession and unemployment. In other words, the pro-cyclical fiscal policy in the expansionary phase of the normal cycle leads to the loss of fiscal policy during the recession and the exit from recession.

I will show, however, that if the short-term Phillips curve is flattened (excess demand generates relatively low levels of inflation), then it is likely for inflationary pressures that lead to higher interest rates during the normal phase not to emerge anymore. In an environment of relatively low inflation and interest rates, along with a pro-cyclical fiscal policy, it is highly likely that the entry into recession triggers an abnormal phase of the business cycle, when monetary policy rates hit the zero mark without the economy returning to potential, which would entail the loss not only of the fiscal policy, but of the conventional monetary policy as well.

2. A cognitive explanation of pro-cyclical policies in democracies with weak institutions

Most economists and analysts have explained the pro-cyclical fiscal policy in Romania during expansionary phases of the economy through populism and lack of knowledge of the implications of a pro-cyclical fiscal policy. In other words, according to these authors' explanation, the promoters of such a policy believe they are right in their actions, without realizing that they might add problems to inflation management in the expansionary phase of the business cycle or that they definitely contribute to higher unemployment thereafter. This explanation is similar to that suggested by Rogoff and Reinhart (2008) through the phrase 'this time is different', which also implies the lack of knowledge, not necessarily of the negative effects, but of the unavoidability of a crisis.

However, part of this explanation – namely that regarding the obliviousness of the harmful effects or inevitability of a crisis – might not be correct. Economists have repeatedly explained that, in an economy such as Romania, a pro-cyclical fiscal policy in the expansionary phase is almost doomed to remain pro-cyclical during the downturn as well, deepening unemployment. Figure 1 depicts the pro-cyclicality of the fiscal policies in Romania through positive (negative) fiscal impulses and positive (negative) output gaps simultaneously at work. It can be seen that pro-cyclical fiscal policies in expansionary phases have remained pro-cyclical during downturns and for quite a while afterwards as well. This brings up the question of why a government would want to implement pro-cyclical fiscal policies if it can anticipate their detrimental effects on voters. *In extremis*, in a cognitive approach, like the one proposed herein, there can only be two answers: governments either use those detrimental effects as a means to a political end or believe they can dodge such effects. I will explore the two possibilities one by one.

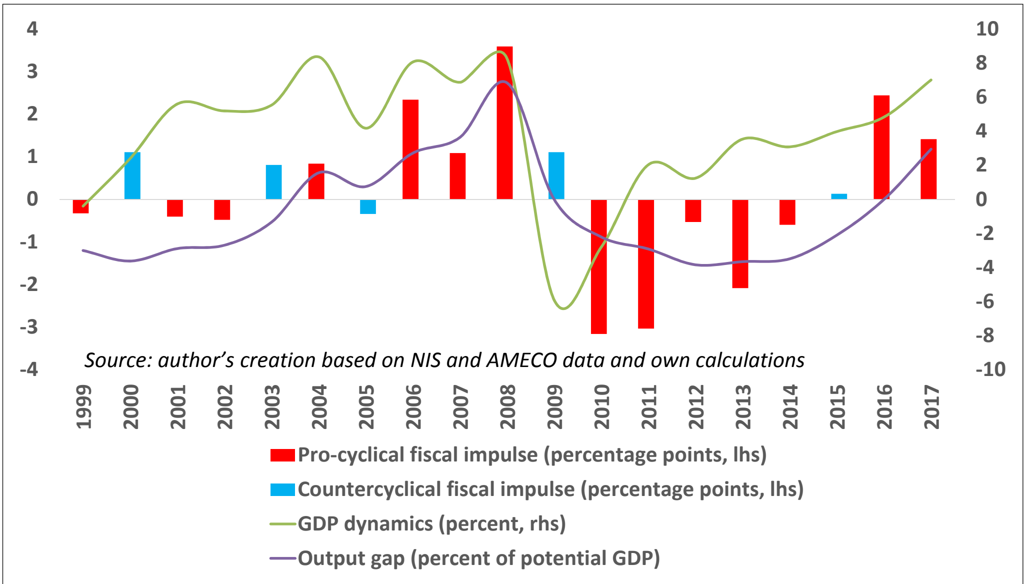

Figure 1: Pro-cyclicality of fiscal policies in Romania determined based on the primary fiscal impulse and the output gap (forecasts for 2017)

2.1. The 'fiscal cynicism' assumption

Capitalizing on the harmful effects can be an end only in a democracy with weak institutions. My explanation, which I call the 'fiscal cynicism' explanation, is that – in such a democracy – there may emerge a logic of alternance in power whereby the costs of a pro-cyclical fiscal policy will be borne by the current opposition (future ruling party), which will weaken and reduce it in favor of the current ruling party (future opposition). By virtue of this logic, any party coming to power during the upswing of the business cycle would promote pro-cyclical fiscal policies.

This explanation assumes there are political parties or coalitions that embark on a path of maximizing their political market share over the long term, and decide to govern, if they can, in all periods of economic expansion, which they amplify via pro-cyclical policies in order to weaken their political foes, and not to govern in any recessions. As I will show at the end of this section, in Romania we can identify a party that has so far governed almost exclusively during upturns of the business cycle and promoted pro-cyclical fiscal policies each time. However, we have no grounds to claim that governing solely during upswings was or was not part of a strategy pursued by the said party or that it was guided or not by cynical or benevolent intentions. It is not the aim of this article to determine what intentions or strategies have guided or are guiding the pro-cyclical fiscal policies of political parties. The aim of the article is to identify the possible explanations for these pro-cyclical fiscal policies, and to infer the implications that arise if, for whatever reason, one and the same party governs during all business cycle upturns and promotes pro-cyclical fiscal policies.

The objective of governing solely during periods of expansion (not at all in recessions) is rational from the perspective of a cognitive bias of the public: the significance in terms of advantages and disadvantages that an unanticipated gain has compared with an unanticipated loss of equal magnitude is stronger in case of the loss. As I have shown in another article (Croitoru, 2017), the first economist to write about this cognitive bias was Knut Wicksell (1898, p. 3). In virtue of this cognitive bias, losses emerging in recession are perceived more strongly in absolute value than gains during upswings. Thus, if a party that governs in the expansionary phase of the business cycle and promotes pro-cyclical fiscal policies were to govern during the ensuing contractionary phase as well, its image would be seriously dented. By contrast, governing exclusively during periods of upturn, there is increased likelihood for the respective party to be associated by the public with the idea of success and welfare.

In the theory of fiscal cynicism there are no guarantees about how long an expansion can last. Expansions can be very brief. For instance, in the US, the shortest upturn after World War I lasted 12 months. In theory, as time goes by, the economy nears a potential recession which can set in anytime. Hence, for parties maximizing their market share by governing only in virtually all times of economic expansion, in the logic of fiscal cynicism there arises, on one hand, the need for fiscal policy to be pro-cyclical from the beginning and, on the other hand, the urge to step down from power immediately after the possible entry into recession. Moreover, it is sensible that the pro-cyclicality of fiscal policy should heighten towards the end of the governing period, which coincides in time with the approaching of parliamentary elections. Heightened pro-cyclicality may ensure the success in the forthcoming elections of the party that governs solely in the expansionary phases, without any political damage in the future. If, after winning the elections, the economy is hit by recession, the logic of fiscal cynicism dictates that the respective party steps down, so as not to pay the cost of the expansionary fiscal policy it promoted.

The explanation I have put forward triggers immediately two questions: why the ruling parties that promote fiscal cynicism are not penalized by voters? And why the other parties do not adopt strategies to prevent the governing of one and the same party only in the expansionary phases of the business cycle?

The answer to the first question is that the lack of sanctions from voters owes to the influence of three factors. One such factor is none other but the aforementioned cognitive bias of the public at large, to whom the significance of losses is greater when compared to that of gains of equal magnitude. Another factor is that, while almost all voters can understand during an economic upturn the immediate beneficial effects of pro-cyclical fiscal policies, the majority cannot comprehend how the negative effects of these policies, which usually become manifest under a different administration, during a downturn, are ascribable to the previous governance. Briefly put, most voters cannot understand that the negative economic effects in the contractionary phase are rooted in the pro-cyclical fiscal policy promoted during the expansionary phase. From a cognitive perspective, in the explanation put forward here, the administration is aware and voters are oblivious of the detrimental effects over the longer horizon of fiscal policy, meaning there is a cognitive asymmetry at work. Finally, the third factor is short memory. Most of the voters who understand would forget by the time of the following elections that the costs emerging in recession are partly rooted in the pro-cyclical fiscal policies pursued by governments during periods of expansion. The three factors listed here, i.e. cognitive bias, cognitive asymmetry and short memory, are mutually reinforcing.

Regarding the second question, the answer is that the lack of a strategy of the other parties to render it impossible for one and the same party to govern only during all business cycle upswings promoting pro-cyclical fiscal policies reflects a coordination failure. Essentially, the other parties (namely those that do not succeed in governing during upturns) fail to come up with a coordinated refusal to govern in recessionary periods. In our view, the underlying reason for this failure relates to the fact that institutions in our democracy are weak. That is why the complex structure of incentives prompting the decision to assume power is deeply skewed in favor of decisions spanning the short-term horizon. For those who repeatedly fail to govern during upswings, the incentives to rule in recessions are so strong that those who have a chance to do it cannot adhere to a strategy implying abstention from governing. This outcome is known to the party that governs only during all business cycle upswings by promoting pro-cyclical fiscal policies. The parties' failure to coordinate, in conjunction with the lack of sanctions from voters, generates – in democracies with weak institutions – a very serious consequence: a party that manages to govern from the very beginning in the expansionary phase of the business cycle and promotes pro-cyclical fiscal policies has the highest chances of governing during the next business cycle upturns as well, while it is optimal – for the reasons stated above – not to rule in recessions.

The fiscal cynicism explanation implies various degrees of severity of the pro-cyclical fiscal policy. To reflect the maximum damage, the explanation is worded as follows: in a democracy with weak institutions, the administrations in the expansionary phase of the business cycle use the pro-cyclical fiscal policy in order to cripple the administrations in the contractionary phase all the way to extinction. This severe form of pro-cyclicality might be the only one preferable for those who intend to govern solely during all periods of economic boom, since it leaves political adversaries with very little room for maneuver, while maximizing the public's positive perception vis-à-vis the governance during the economic expansion.

In Romania, evidence seems to support the idea that the pro-cyclical fiscal policy pursued in all expansionary periods inflicted maximum damage on the parties that managed the effects during periods of recession and exit from recession. Each recession occurring after 1990 that had been preceded by an expansionary fiscal policy ousted from the political stage either the party perceived as leading a governing coalition during the recession or the party that formed the government during the downturn. That is what happened to the Christian Democrat National Peasants' Party (PNȚCD) after the 1997-1999 slump, and to the Democrat-Liberal Party (PDL) after the 2009-2010 recession. Data in Figure 1 validate the hypothesis that, in Romania, the pro-cyclicality of fiscal policy emerges from the very start of governances in business cycle upturns and becomes more visible during the closing years of the respective tenures, as stated by our fiscal cynicism theory.

At present, the ruling coalition in Romania is pursuing a strongly pro-cyclical policy, as illustrated by Figure 1. Based on previous experience, it results that the party coming to power or leading a governing coalition after the 2020 parliamentary elections, or even sooner, if a crisis breaks out, will have difficult problems to solve if the economy enters a recession. The respective administration will not only be unable to use the fiscal policy to take the economy out of recession and speed up the return of output to potential, but it will delay these processes because it will be coerced to cut budget spending and raise taxes. Such measures might trigger voters' ultimate aversion, similarly to what happened after the parliamentary elections of 1996 and 2008.

The founding elections of 1990 brought to power in Romania a party which, either directly or by supporting parties that did not have a parliamentary majority, governed in virtually all expansionary phases of the business cycle, always promoting pro-cyclical fiscal policies, but almost never ruled when the economy was mired in recession. Readers should be reminded that it is not our aim to determine whether governing solely during business cycle upswings and systematically promoting pro-cyclical fiscal policies are part of a strategy or are the outcome of a cynical or benevolent intention.

But, looking beyond intentions, the aforementioned findings are the same as those that would come up if the respective party were to govern only in all expansionary phases and to implement pro-cyclical fiscal policies with the intention of getting rid of its foes, like in the fiscal cynicism hypothesis. If the trend persists, this particular party will become very big and will no longer have any real political opponents after 2024. A democracy where there is no political struggle will eventually be altered. Essentially, this is the direst political cost that strongly pro-cyclical fiscal policies could entail in Romania.

2.2. The 'constrained responsibility' hypothesis

The other hypothesis I put forward in order to explain why the parties governing during economic upturns implement pro-cyclical fiscal policies is that pro-cyclicality advocates have the necessary knowledge to fathom the risks posed to inflation and unemployment, as in the fiscal cynicism explanation, yet are benevolent. More precisely, the promoters of pro-cyclical fiscal policy are guided by the belief that the associated risks will not materialize before shifting to a correct countercyclical policy, later on, after they have reached the seemingly non-delusional objectives pursued, for instance, via tax cuts alongside significant pay rises.

This explanation assumes, similar to the fiscal cynicism theory, that detrimental effects (costs) may occur under the governance implementing the pro-cyclical fiscal policy in the expansionary phase of the business cycle. But, unlike the fiscal cynicism theory, it additionally assumes a 'responsibility' of the fiscal policy initiators towards the public and political adversaries. 'Responsibility' is manifested in the intention of a 'timely' reversal of the pro-cyclical nature of fiscal policy, i.e. prior to the outbreak of a crisis that would halt the upturn of the business cycle. The timely shift would allow fiscal policy to become countercyclical, meaning that it can be used in the contractionary period to foster economic growth, thereby facilitating the task of the incoming government, which can be one and the same with the government having promoted the pro-cyclical policy.

This 'responsibility' does not show up out of the blue. On the one hand, it might be generated if there were evidence prompting the governing party to believe it could stay in power for two successive electoral cycles. On the other hand, it is triggered by the awareness of a high likelihood that the business cycle upswing might be interrupted by the occurrence of a slump during that particular term in office. We can now say that we are dealing with a responsibility 'constrained' by the prospects of recession.

If we assume, without it being an assertion, that this knowledge and the belief in the 'timely' reversal of the fiscal policy nature – which I have already brought up – lie at the root of pro-cyclical fiscal policies in Romania, then shifting to the implementation of the expansionary pro-cyclical fiscal policy as early as 2016-2017 would reflect two implicit wagers. The first is that monetary policy will somehow succeed in keeping inflation within the range targeted by the central bank, despite the relatively wide structural budget deficit, without creating discontent for the public.

The decision to tighten monetary policy is, however, not an easy one. On the one hand, if it did not raise the interest rate to tackle inflation, monetary policy would contribute, as I am about to show, to the widening of the structural budget deficit, while the leu would weaken in the anticipation that macroeconomic policies are unsustainable, which would be visible in inflation. In this case, the inflation wager would be lost and, from the perspective of those who bet on inflation staying low, it would have costs in terms of future votes.

Alternatively, inflation might continue to stay low for a long period if, following the earlier structural changes or those recently generated in the aftermath of the 2008 crisis, the link between excess demand and inflation has been greatly weakened. Thus, inflation readings close to the lower bound of the variation band around the flat inflation target set by the central bank may coexist for a while with an inflationary, even rising, output gap, without requiring a policy rate hike to narrow the output gap. That is why, alongside the widening of the private sector's external imbalance, two highly costly consequences emerge from the relationship between monetary and fiscal policies.

The first is that, having no reasons given by prospects of higher inflation to reduce the output gap to zero, monetary policy contributes to the strengthening of fiscal policy pro-cyclicality. This effect occurs if the headline budget deficit becomes an implicit target. Such a target appears when the adopted fiscal measures tend to raise the headline deficit above a certain limit, for several years in a row, but there are forces (such as the rules in the European Union) which impose sanctions that make the deficit stay at the maximum admitted limit by rules. In this case, even if the headline budget deficit remains constant for a number of years as a percent of GDP, the rise in the excess demand (GDP gap) leads to the widening of the structural budget deficit from one year to another, as I have previously mentioned. In this way, by refraining from tackling excess demand, a pro-cyclical monetary policy in the expansionary phase of the business cycle would add to the severity of the fiscal adjustment in recession, contributing to higher unemployment. The second consequence, which I will dwell upon in the next section, is that a pro-cyclical fiscal policy may lead, with the entry into recession, to the loss of the monetary policy's operational tool.

On the other hand, tackling inflation might require relatively large increases in the monetary policy rate in Romania. This would strain the balance sheets of the indebted, likely to generate the emergence of the financial frictions that will entail a slowdown in economic growth or, in the worst case, a recession.

The second implicit wager I have referred to is that the expansion of the world economy will not come to a halt in the period when our fiscal policy is pro-cyclical and that, as it has happened in Romania so far, a recession will not be generated exclusively on domestic grounds. In other words, it is a bet that global growth will extend beyond the moment marking the deliberate return of domestic fiscal policy to the countercyclical profile. It is a bet on the approximate date of the outbreak of the following crisis (recession) in a large country, which may influence the business cycle globally, meaning that it is a bet against the economic cycle. This bet reflects the belief that, within the same expansionary phase of the economic cycle, fiscal policy can first be pro-cyclical, in order to attain some goals, and it can then be turned into a countercyclical policy even before the upturn has ended, in virtue of the constrained responsibility. From another perspective, fiscal policy is pro-cyclical from the beginning in order to maximize the chances of not facing a crisis during the deliberate period of pro-cyclicality and to stand a higher chance of being turned from pro-cyclical into countercyclical in due course. This belief is, usually, illusory. The data I have presented for Romania in Figure 1 show that our fiscal policy has never been relentlessly countercyclical. Briefly put, I call this belief the illusion of the 'timely reversal' of fiscal policy from pro-cyclical to countercyclical.

Since the illusion of the timely reversal cannot be done away with, the pro-cyclical fiscal policy pursued from the perspective of constrained responsibility would have the same negative economic effects for the following governance and for each and every one of us. However, it would not exert the same negative effects in the long run on democracy as fiscal cynicism, because presumably the party pursuing it does not wish to govern solely during expansionary phases of the business cycle.

Nevertheless, this neutral result on democracy would be different if we were to change the constrained responsibility hypothesis to allow one and the same party to govern, with the benevolent intention of 'timely reversal', only during all business cycle upturns. We thus derive the 'altered constrained responsibility' theory, which is a particular case of the constrained responsibility theory, where the respective party is benevolent not only to the public and political foes, as in the initial definition, but also to itself, since it avoids governing in recession. With these changes, the constrained responsibility theory yields the same negative results with regard to democracy as the fiscal cynicism theory.

In order to be clearer on the similar negative results on democracy of both fiscal cynicism theory and altered constrained responsibility theory, I reiterate that the founding elections of 1990 in Romania made it so that, without governing during downturns, one and the same party governed directly or indirectly (by supporting a minority government) in virtually all business cycle upswings ever since 1990. Assuming this party has so far always pursued and were to pursue from now on as well pro-cyclical fiscal policies with the benevolence implied by constrained responsibility, and were to continue to govern only during all expansionary phases of the business cycle, then it is highly likely the party will no longer have any real opposition starting 2024. It is the same result obtained in the logic of fiscal cynicism as well.

Now we can clearly state that it does not matter whether a party is cynical or benevolent when pursuing a pro-cyclical fiscal policy. What matters is if, by pursuing the pro-cyclical fiscal policy, the respective party has the strategy, without governing in any recession, to govern in virtually all business cycle upturns and manages to implement it. Any political party or coalition meeting this condition will end up having no political adversaries that count. In this way, the said party or coalition may profoundly alter democracy.

Having defined the two hypotheses – that of ‘fiscal cynicism’ and that of ‘constrained responsibility’ –, it becomes clear that, in the cognitive approach adopted in this paper, if considering strictly a given governance, rejecting the ‘constrained responsibility’ hypothesis automatically means accepting the ‘fiscal cynicism’ explanation, and vice versa. However, if we have in mind the case in which one and the same party governs for a relatively long period in all business cycle upswings, and does not govern during recessions, it cannot be ruled out that certain governances might have been guided by fiscal cynicism, while others by ‘altered constrained responsibility’. Irrespective of the correct explanation, the same party governing in all expansionary phases of the business cycle, without being in power during any recession, along with perpetually promoting pro-cyclical fiscal policies may lead to an alteration of democracy and, depending on the normal or abnormal character of the business cycle, to the loss of interest rate as a conventional monetary policy tool.

3. An assessment of risks of the pro-cyclical fiscal policy from the perspective of normal and abnormal phases of the economic cycle

Even though fiscal policy conversion from pro-cyclical to countercyclical within the same expansionary phase of the business cycle is generally illusive, it cannot however be ruled out. Starting from the assumption that the current political coalition in Romania is ruling guided by ‘constrained responsibility’, the aim of this section is to answer the question whether this time there are chances for the fiscal policy in Romania to become countercyclical in the present expansionary phase of the economic cycle, thereby reducing the odds of losing the interest rate as a monetary policy tool. For this purpose, we shall analyze some traits of the global economic cycle and the conditions in which the next phase of the economic cycle could be ‘abnormal’ for Romania.

3.1. The inevitable recession

We know for sure that a new crisis will come, but we never know when; in principle, a crisis is necessary as it shows us what is wrong in our economic model, i.e. in our business model. Provided we identify correctly what needs to be fixed, we can lay the groundwork for a lasting expansion, in which imbalances build up slowly and economic growth is high. If we identify them incorrectly imbalances may build up fast and expansion will be brief. With a wrong identification, even if the economy were to grow at a fast pace under the influence of incidental factors, the shorter duration of the upturn might make it so that the expansion-generated production gain trail behind the outcome of the correct identification of the underlying causes and the adjustments needed.

Admitting that the experience will recur, Romania’s economy will not enter recession before being forced by a crisis generated outside it. Such a crisis affecting the domestic economy as well should erupt in a large country, with strong ties to the European Union, the main destination of Romanian exports. Such an economy is the US, which is the largest world economy and the leading trade partner of the European Union.

Several parameters of this economy prompt us to believe it will not be long before a new crisis (recession) hits: a) the economic growth rate during the present expansion has been lower than in the previous two, which might be indicative of the fact that the US economy has not yet conducted all the adjustments required by the 2008 crisis, either because it has not properly identified them or because it was unable to; b) non-financial corporations embarked in 2011 on a new indebtedness cycle, with the annual pace of increase of debt exceeding 6 percent in 2015; c) the ratio of net debt to funds from operations has followed a steep upward path since 2015, and has exceeded 170 percent, above the 2009 reading; d) the average credit cycle spans 6-7 years, whereas the aforementioned expansion of credit to non-financial corporations since 2011 shows that this cycle is drawing to an end of its average length; e) finally, although it is known that expansions do not die of old age, it is also worth mentioning that the longest expansion in US history lasted for 10 years; the ongoing one has already been around for 8 years. For the time being, the negative signals coming from these data are alleviated by the fact that the credit cycle is barely at the beginning in the euro area and Japan, while in the US the government and households increase their debt at slow paces, of 5 percent and 3 percent per year respectively.

Under these circumstances, it may be assumed that Romania's fiscal policy might be caught on the wrong foot, meaning that it cannot be turned from pro-cyclical into countercyclical in due course, losing the implicit wager referred to above. Moreover, turning the fiscal policy from pro- to countercyclical cannot be done overnight, it takes time. This shows that economic expansion might be halted by a crisis before the 'timely reversal' of the fiscal policy.

3.2. The emergence of the 'abnormal-recessionary' phase and the loss of conventional monetary policy

In order to evaluate the consequences of the pro-cyclical fiscal policy during the economic boom, we should correctly identify the phase of the economic cycle that the economy will be in. I am not referring here to the uncertainties associated with the econometric estimation of the excess demand, which is an unobservable variable. I am referring to the fact that the business cycle is more complex than it was generally believed prior to the 2008 crisis.

In light of the experience, the economic cycle can no longer be judged as a succession between the upturn and the downturn of the business cycle, in which monetary policy rates are significantly positive. The crises – starting from that of 1929 and all the way to that of 2008 – have shown that the economic cycle has a 'normal' phase, in which policy rates are significantly positive, and an 'abnormal' one, in which the said rates are zero or even negative.

In each of these phases, the periods in which the economy is in expansion alternate with periods in which the economy is in recession. Thus, the economy can be in one of the four possible phases: (i) normal-expansionary, (ii) normal-recessionary, (iii) abnormal-recessionary, and (iv) abnormal-expansionary. The macroeconomic policy mix is conditional on the phase of the economy, which makes it so that the key role is not always assumed by the same policy (Croitoru, 2016). An example of the four phases of the economic cycle for the US economy is shown in Figure 2.

Having clarified these phases, it can be seen that, once the economy enters a recession after a normal-expansionary phase, such as the one that started shyly in Romania in 2011, and has already led to economy overheating in 2017, in which fiscal policy was pro-cyclical, the emerging effects depend on the phase that comes next.

If the next phase is the normal-recessionary one, in the worst case fiscal policy might continue to be pro-cyclical during both the recession and much of the period when output would remain below potential, even if the economy grew at positive rates. But, very important for the reasoning here, monetary policy will have the necessary room to cut interest rates enough to help the economy exit the recession quickly. In other words, monetary policy will not lose its operational tool, namely the interest rate.

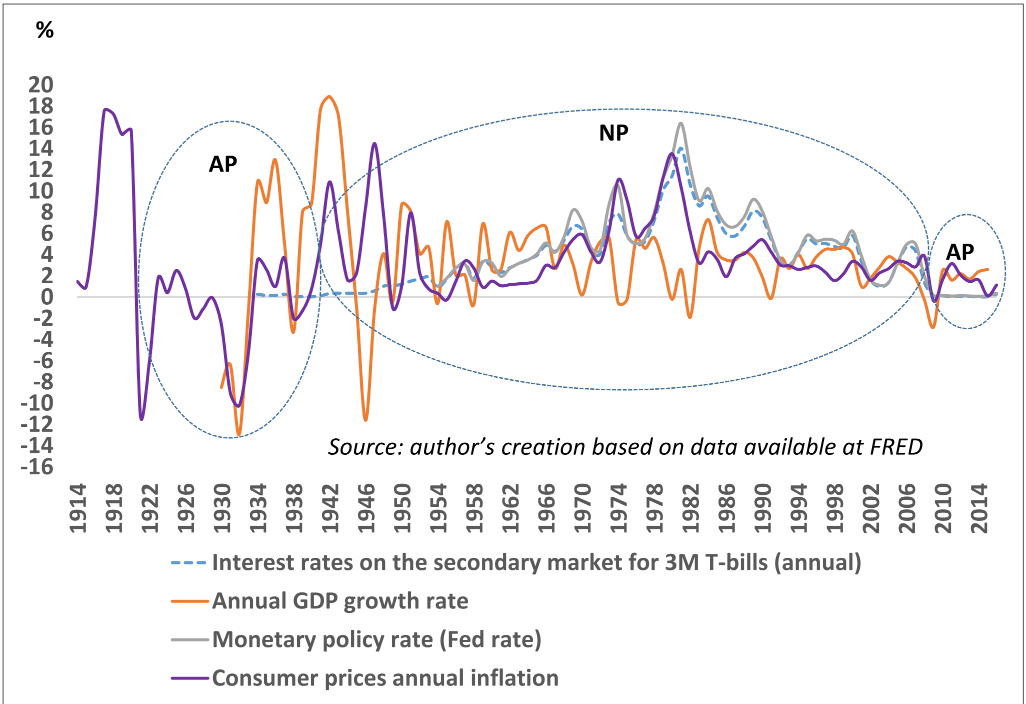

Figure 2: 'Normal' phases (NP) and 'abnormal' phases (AP) of the business cycle in the US

Nonetheless, the normal-expansionary phase may be followed by the abnormal-recessionary one, as it happened with the 2008 crisis, when aggregate demand witnessed a massive drop in developed countries. In this case, the asymmetric contribution of the pro-cyclical fiscal policy can lead to the loss of the monetary policy operational tool. On one hand, in the expansionary phase, the pro-cyclical fiscal policy made a relatively small contribution to the increase in the interest rates, which created additional room for monetary policy. On the other hand, however, in the abnormal-recessionary phase, fiscal policy may remain pro-cyclical, substantially contributing to the deepening of the recession and of the unemployment, calling for a major cut in the interest rate, as in the case of the normal-recessionary phase, or it may remain insufficiently countercyclical. Now, however, unlike the normal-recessionary phase, the interest rate cut to zero is no longer sufficient to help the quick exit from the recession. Now, since it widened too much in the normal-expansionary phase, the fiscal deficit either needs to be diminished or can no longer be sufficiently increased to make up for the decline in private demand, with monetary policy having to try to boost aggregate demand via quantitative easing. The less indebted in foreign currency the economic agents are and the larger the stock of instruments available for such operations, the higher the success of such a policy in Romania.

In the case depicted here, the monetary policy of quantitative easing is a consequence of fiscal policy pro-cyclicality. Or, otherwise stated, monetary policy loses its operational tool because fiscal policy was pro-cyclical in the expansionary phase of the business cycle. This scenario was confirmed after 2008 mainly by the developed economies, but also by an emerging one: the Czech economy.

In developed economies, the loss of interest rate as a monetary policy tool occurred because policy rates had been relatively subdued prior to entering the Great Recession of 2008, and fiscal deficits could not be sufficiently widened to make up for the fall in demand to levels at which the natural interest rate became too low. Essentially, the sufficient widening of deficits was impossible either because, in some cases, fiscal policies had been pro-cyclical during the upswing or because of governments' fear that an overly large increase in the deficits might have not been financed by markets, which would have also affected economic agents' confidence, already at very low levels.

Looking at the Czech Republic, structural budget deficits before the crisis had been relatively wide, so that the entry into recession for the second time after 2008 called for fairly large cuts in the structural budget deficit, of 1.5 percentage points in 2011, 1.1 percentage points in 2012, and of 1.6 percentage points in 2013. In other words, the Czech Republic lost fiscal policy because it could not expand the budget deficit in order to stimulate the economy. The Czech Republic' central bank bought a total of 76 billion euros, which was tantamount to injecting korunas into the economy, i.e. it pursued a less common form of monetary policy based on quantitative easing.

3.3. Abnormal-recessionary phases will extend across countries and will become more frequent

The discussion in the previous paragraph on pushing the economy by a pro-cyclical fiscal policy in the abnormal-recessionary phase and on losing the interest rate as a monetary policy tool was based on two hypotheses. The first assumes a significant flattening of the Phillips curve at the low levels of the inflation rate, including in Romania. Were this flattening not to take place, inflation would pick up at higher paces as output rises towards potential. The second hypothesis is that the natural rate of the interest might drop to very low levels. With these two assumptions, cutting the monetary policy rate to zero would not suffice to push the real monetary policy rate (which, in this case, is equal to zero minus inflation) below the natural interest rate because inflation would be too low.

Arguments and evidences to support these hypotheses are available in Bernanke (2005, 2007 and 2015), Borio and Disyatat (2011, 2014), Borio (2017), Carney (2017) and Croitoru (2015). These papers show that global factors and technological changes lead to: (i) the decline in the interest rates and in the natural rate of interest, (ii) the change in financial conditions, and (iii) the flattening of the Phillips curve.

The materialization of these hypotheses is underway in Romania, and they might fully materialize in the next two to three years. During this time span, as I have argued above, the US economy may enter into recession, triggering a recession in Romania as well. With the aforementioned hypotheses materialized, and with a fiscal policy that seems programmed to stay pro-cyclical over the next two to three years, the upcoming phase of the business cycle is highly likely to be abnormal-recessionary, meaning that the interest rate can no longer play the role of a monetary policy tool.

The low natural rates of interest and the flattening of the Phillips curve will prompt the interest rates and the inflation rates in various countries, Romania included, to stick to relatively low levels. Against this background, if recession sets in, our economy will need a relatively large policy rate cut to resume growth. Since interest rates will probably be too close to zero, it is also likely that monetary policy might not be able to deliver the necessary reduction in the policy rate. After lowering the interest rate to zero, the real rate of the interest is equal to minus inflation. If inflation is low too, as we have assumed, then the real monetary policy rate is negative and relatively high (let us admit, for the sake of a comparison I am about to make, that it is, for example, minus one percent).

From this point, the resumption of economic growth hinges on the level of the natural interest rate and on the fiscal policy. If the natural rate of the interest has dropped below the level to which the real monetary policy rate can be cut (minus two percent, for instance), then monetary policy (whose interest rate could only be lowered, in our example, to minus one percent) can no longer contribute via conventional tools to stimulating demand. Now it takes expansionary fiscal policies to stimulate demand. This would shift the demand curve upwards enough to raise the natural rate of the interest to levels from which monetary policy would regain its strength with conventional means. The only thing is that, having been pro-cyclical during the economic upturn, fiscal policy is very likely to stay so in recession as well, unable to help with the resumption of economic growth and with the regaining of the monetary policy. This is the mechanism which may lead to the loss of monetary policy that I have referred to in the first two sections of the article.

In this way, the pro-cyclical fiscal policy in the expansionary phase might push our economy into an abnormal-recessionary phase, which it can exit only by resorting to unconventional solutions. The loss of conventional monetary policy is the highest economic cost Romania could pay for promoting pro-cyclical fiscal policies.

4. Conclusion

In this paper, I have shown that if, in a democracy with weak institutions, fiscal policymakers are aware of the potential negative effects associated with promoting a pro-cyclical fiscal policy, there are two explanations for accepting the pro-cyclicality of fiscal policy. When the ruling political coalition is not benevolent and succeeds in governing solely during virtually all normal-expansionary phases of the business cycle, 'fiscal cynicism' emerges: the pro-cyclical fiscal policy is promoted in the expansionary phase for the temporary benefits it brings to the ruling coalition and for the difficulties it poses, thereafter, to the political opposition. When the ruling political coalition is benevolent, a 'constrained responsibility' occurs: the pro-cyclical fiscal policy is promoted in the normal-expansionary phase with the intention that, after meeting some economic and political objectives, it should be turned into a countercyclical fiscal policy well before the economy enters a recession. I have shown that the timely reversal of fiscal policy from pro- to countercyclical is illusive, so that negative effects emerge for those ruling in recession, as in the case of fiscal cynicism. Thus, the constrained responsibility turns into an 'altered constrained responsibility' if the benevolent political coalition succeeds in governing solely during virtually all normal-expansionary phases of the business cycle.

I have shown that, by practicing either fiscal cynicism or altered constrained responsibility, a political party or coalition will end up dominating the political stage, without any real opposition. Both the theory of fiscal cynicism and that of the altered constrained responsibility explain well the disappearance of major parties from the Romanian political stage after the recessions of 1997-1999 and 2009-2010, and indicate that a single very large party may end up dominating the stage, thus altering the democracy. It was not our aim to show which of the two theories better explains these outcomes, and which theory applied in various periods from 1990 onwards.

The only real strategy that remains for avoiding the possible serious consequences of a pro-cyclical fiscal policy – erosion of democracy, loss of fiscal policy in recessionary periods and, therefore, possibly the loss of the interest rate as a monetary policy tool – is to strengthen institutions, whose improved quality should stand as a guarantee that good fiscal rules are applied, preventing the emergence of pro-cyclical fiscal policies.

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